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Nos. 323 and 324.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1929.

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

VS.

KANSAS CITY STRUCTURAL STEEL COMPANY, RESPONDENT.

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VS.

KANSAS CITY STRUCTURAL STEEL COMPANY, RESPONDENT.

BRIEF ON BEHALF OF RESPONDENT, KANSAS CITY STRUCTURAL STEEL COMPANY.

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BRIEF ON BEHALF OF RESPONDENT, KANSAS CITY STRUCTURAL STEEL COMPANY.

(1) There was no income upon which to assess the tax.

(2) The Inventory Statute and the Departmental Regulations made in pursuance thereof are not applicable to respondent's business nor to the emergency material in question.

Respondent asserts and petitioner denies the correctness of the above propositions, the second being but a corollary of the first, for, as of course, there

can be no tax without income. The court below upheld respondent's contentions and reversed the judgment of the United States Board of Tax Appeals which held to the contrary. Consequently, we conceive it to be our proper duty (fully and accurately, but as briefly and succinctly as we can), to present and apply the agreed facts that it may be determined therefrom whether there was any income constituting the subject of the tax and also whether the Inventory Statute and the regulations thereunder are applicable and serve to aid in determining the primary question, viz.: Was there any income upon which to assess the tax?

The judgment of the United States Board of Tax Appeals was promulgated April 30, 1928, affirming, by a divided vote, the action or judgment of the Commissioner of Internal Revenue in assessing an additional or deficiency income tax against the respondent for the years 1918 and 1920. Upon appeal of the taxpayer, this judgment was reversed by the United States Circuit Court of Appeals for the Eighth Circuit. The cases are here, by certiorari, upon petitions of the Commissioner of Internal Revenue. The tax was made up of several items, but this case involves only the portion based upon an alleged gain in inventory of 5554 tons of unfabricated structural steel and steel plates set aside and kept on hand for emergency use. The other items, not here involved, have since been paid.

The cases, as to both years, were tried and submitted upon one agreed statement of all the facts, which will be found at page 16 of the printed record. The disputed tax for the year 1918, amounts to $7,656.74

(Case No. 323) and for the year 1920, to $15,953.36 (Case No. 324). The latter case was submitted below upon the record in the former, pursuant to the stipulation set forth on page 44 of the record in this court. The same situation exists here, for, as said in the stipulation referred to, "the questions of law involved * * * are identical * * * and * * * the facts are similar with the exception of certain amounts and the years involved."

The Facts.

The respondent was engaged in the business of fabricating and erecting, by contract, structural steel and steel plates for buildings, bridges, tanks and other structures. It fabricated and erected such material for each specific structure and contract. Material was ordered and procured, at the then market price, from the rolling mills for each specific structure and contract. However, a supply of material was kept on hand for emergency use only (under the practice herein set out) to insure the prompt and orderly execution of contracts, in view of delays incident to shipments from the mills and other exigencies affecting the availibility for use, when needed, of the material theretofore ordered and procured for the particular and specific jobs. The uniform and consistently observed plan and practice was that when, in such emergencies, material was so used from such supply, it was charged to the contract at its replacement cost, viz., the cost of the material already purchased, and upon receipt of the like material previously purchased for the particular job

upon which such emergency material was used, was promptly replaced with material of a like kind and in a like quantity. The respondent was not a merchant, dealer or manufacturer and such material was not for sale and did not constitute a merchandising stock. On the contrary, it was a construction or building contractor for the delivery of the completed structure in place, involving and embracing all labor and material. The emergency material was very heavy and was kept in convenient piles of like kind. When such material was so used it was taken from the top of the pile (the Commissioner of Internal Revenue assumed it was taken from the bottom) and the replacement material was put on top of the pile from which the used material was taken or borrowed. The amount of such material on hand on December 31, 1916, was 5554 tons, which the respondent set aside and substantially maintained for such emergency use (and not otherwise) under the practice aforesaid, and carried it at its cost of $1.70 per hundred weight f. o. b. Pittsburgh, Pa. An alleged gain in inventory of this material forms the basis of the tax in controversy, which is in addition to the tax upon the respondent's income derived from the normal conduct of its contracting business determinative as of the year of the completion of the contracts.

The respondent contends that no income did (nor could prior to final liquidation) accrue from such emergency material as a basis for the imposition of the tax complained of, whereas the Commissioner of Internal Revenue priced the same at the end of the year

at the cost of a corresponding quantity of the most recent purchase of similar material and assessed a tax upon an assumed income based upon the difference between the value thereof, as of December 31, 1917, and December 31, 1919, respectively, and the higher value thereof, as of December 31, 1918, and December 31, 1920, respectively. This resulted in a fictitious increase of the respondent's taxable income, and the additional or deficiency tax which is in controversy.

The stipulation of facts upon which the case was tried provides (R. 16):

> "The company is engaged in the fabrication and erection of structural steel plates for buildings, bridges, tanks, etc. It fabricates material for specific structures or contracts and carries no finished product in stock. Material is ordered and procured from the mills for each specific structure or contract, except that a supply of material, as shown in Exhibit A, has been kept on hand for emergency use (from which material is borrowed and replaced) to insure the prompt and orderly execution of contracts in view of delay, etc., incident to shipments from the mills and other exigencies affecting the availability for use when needed of material ordered for a particular job. When such material is used it is charged to the contract at its replacement cost and is promptly replaced with material of a like kind and in a like quantity" (R. 16).

> "The company, at the end of the years 1916, 1917, 1918, 1919 and 1920, valued its said supply of 5554 tons at the cost price prevailing at the close of 1916, or $1.70 per hundredweight f. o. b. Pittsburgh" (R. 17).

"The Commissioner of Internal Revenue in pricing the inventory of the company has disregarded the said fixed quantity of 5554 tons assuming that the last purchases represented the entire inventory and using said last purchases as a basis for valuation" (R. 17).

The Board of Tax Appeals, in its opinion, said (R. 20):

"The petitioner is a corporation organized and existing under the laws of the State of Missouri, with its offices at Kansas City, Missouri.

During the taxable year it was engaged in the fabrication and erection of structural steel plates for buildings, bridges, tanks, etc., and fabricated material for specific structures or contracts. It carried no finished product in stock. Material was ordered and procured from the mills for each specific structure or contract, except that a supply of material was kept on hand for emergency use to insure the prompt and orderly execution of contracts. When such material was used, it was charged to the contract at its replacement cost and promptly replaced with material of a like kind in a like quantity."

The theory on which the Board decided the case is disclosed by the following language used by it (R. 24):

"In fact, however, each sale or exchange of the individual items of the inventory is a realization of taxable profit or deductible loss in the year in which it occurs, and a method of accounting which disregards such realization does not truly reflect income. After the profit is realized it is immaterial whether it is immediately reinvested in inventory or is invested in some other manner. It is taxable when realized."

I.

The respondent contends that this 5554 tons of material contributed nothing to its income and had no relation thereto; and that therefore there was no income upon which to assess the tax.

As stated, the case was tried upon a stipulation of the ultimate facts, amounting to a special verdict with which the judgment must be in harmony (*Wastun* v. *Lincoln Nat. Life Ins. Co.*, 12 F. (2d) 422). Moreover, it was the duty of the Board of Tax Appeals to supplement (as this court will do) the agreed facts with its judicial knowledge "of the general course of business and the usual methods of transacting it" (23 C. J. 62) and in connection therewith, to not "close our (its) eyes to the well known course of business in the country" (*Bank of Kentucky* v. *Adams Express Co.*, 93 U. S. 174, 185).

The Stipulation of Facts, so supplemented, establishes:

(a) The respondent was a building contractor and not a dealer, producer or manufacturer; and its taxable income and deductible losses resulted from and were limited to its profits or losses accruing from the performance of its construction contracts, determinative as of the date of the completion thereof.

(b) In making bids and contracts, the emergency material was not considered; and the cost, value, existence or non-existence thereof had no relation to the contract, the contract price or the respondent's profits or losses.

(c) Material was purchased and procured for each specific structure and contract prior to the use of any of the emergency material in such structure; and when emergency material was so "borrowed" and used upon a particular structure it was consistently and promptly "replaced" with material of like kind and quantity, normally and naturally utilizing for such replacement purpose the material so theretofore purchased and procured for such specific structure and contract, thus, in truth and substance as distinguished from mere form, preserving the *status quo ante.*

(d) The agreed purpose or object of the use of such material was (and was, concededly, so limited) to insure the prompt and orderly execution of contracts in view of delays in shipment and other exigencies affecting the availability for use when needed of the material theretofore purchased for the specific structure upon which such emergency material was used.

As a construction contractor, the respondent's actual income accrued and was solely derived from the performance of its construction contracts, viz., the difference between the cost of such performance upon the one hand, and the money realized for such performance upon the other. The cost of performing a contract includes and embraces labor, material, insurance, freight and sundry other usual and properly chargeable items of expense. Such cost, when compared with the contract price received, discloses the true income or loss. The aggregate of its completed contracting operations for the year is determinative of its income, upon which

it may be lawfully taxed. The tax in controversy is in addition thereto.

The dissenting opinion of His Honor, Judge Woodrough (R. 40), in this regard, well says:

> "The tax-payer being a contractor, of course its true income for any year was the difference between the receipts from its contracts and the cost to it of fulfillment, due allowances being made."

The following outline, conforming to the stipulation of facts and to the usual course of business, of which the court will take judicial notice, discloses the methods and scope of the respondent's business, its sole source of profits and the relation of the emergency material thereto.

(a) An owner calls for bids from and submits plans and specifications of a proposed structure to those invited to bid. Typical instances are a bridge constructed for the State of Arizona across the Grand Canyon of the Colorado River, the steel frame of the Federal Reserve Bank Building in Kansas City, or a colony of 55,000 barrel oil tanks, in place, for a producing oil company in the Mid-Continent field.

(b) Preliminary to submitting a competitive bid, the contractor estimates the cost of performing the contract upon the basis of the then cost of all material (including steel), labor, insurance, freight, and all other properly chargeable items of expense, first securing from materialmen firm commitments, based upon the then market price, for all the material to be used in the proposed structure, in absolute disregard of the emer-

gency material and of its cost, value, existence or non-existence. These in the aggregate represent the cost of performing the contract. It then adds its contemplated profit to such aggregate cost; makes its bid accordingly; secures the contract containing penalty provisions for delay in completion beyond an agreed time limit and a bonus for prior completion; converts such prior commitments for material into final purchases thereof; and proceeds to the prompt, orderly and expeditious performance of the contract, at the conclusion of which it collects the contract price, plus extras and less deductions, resulting in a then profit or loss, as the case may be.

(c) Since the material was previously purchased, at the then market price, for each specific structure and contract, it is immaterial whether the market price thereof thereafter increased or decreased, for, obviously, such change could not affect the cost of the material so already purchased, or the contractor's profit or loss.

(d) It is likewise obvious that the cost, value, existence or non-existence of the emergency material had no relation to the contract or the contract price and was not considered in making the bid. Its *agreed* relation to and connection with the transaction was limited to the expeditious performance of the contract, or, as stated in the stipulation of facts, to "insure the prompt and orderly execution of contracts," in view of delays in shipments, *et cetera,* affecting the availability for use, when needed, of the material "so purchased and procured." Under these conditions (and not otherwise) it used such portion of the emergency ma-

terial as the emergency warranted or required, charging the same to the contract at its replacement cost, but upon the condition and under the uniformly consistent plan and practice (constituting but a step in the completed transaction) that the portion of the emergency material so "borrowed" and used would be promptly "replaced," normally and naturally utilizing for that purpose the material so already purchased for the particular job upon which the emergency material was used. The use of the emergency material was coupled with the concurring obligation to restore it in the manner specified; and no optional alternative existed to do otherwise without departing from the agreed (and observed) practice.

With these ultimate facts in mind, and viewing the transaction as a whole, the relation of the emergency material to the respondent's business and income may be tested upon every possible hypothesis with the result that it will be irresistibly demonstrated that such material was in no sense a source of income and contributed nothing to the taxpayer's profit (save only the incidental benefits resulting from the expeditious performance of its contracts), and that every financial aspect of the business was handled without regard to it. Let it be assumed that (1) there had been no such material on hand; (2) or, being on hand, no emergency arose for its use; (3) and that its cost, instead of being $1.70 per hundred weight, was nothing, or the highest, or the lowest, figure to which the steel market went at any time; wherein would such situations have affected or changed the respondent's course of business or the

earnings derived therefrom? In other words, if there had been no emergency material on hand at any time, the situation would have been identical, so far as earnings were concerned, and the only difference would have been the want or absence of the prompt and orderly execution of contracts resulting from the delay incident to shipments from the mills and other exigencies affecting the availability for use when needed of material ordered for a particular job. Such are the stipulated facts. Consequently, this material was merely a facility to obviate delays and minimize expense and possible loss *in performance* of contracts, and had and served no other purpose and produced no other result. It was a convenient facility and not a necessity, which is not the case with a producer, manufacturer or dealer to which the inventory regulations apply as will be hereafter pointed out.

We submit the demonstrative illustration that if the taxpayer's operations as a construction contractor had produced neither profit nor loss, leaving only the fictitious income complained of, it would have been without earned funds with which to pay the tax thereon and could look only to its capital and surplus therefor. In such a case, by no system of economics or accounting could there be found a farthing with which to pay the tax, save only, as stated, from capital and surplus. There can be no such destructive conflict between good law and good business, for income is the *sine qua non* of the tax. Substance, not form, controls, and "the letter killeth, but the spirit giveth life" (I Cor. 3:6), an exhilarating doctrine in lively contrast

with the depressing heresies announced by the Commissioner of Internal Revenue and Board of Tax Appeals in this case.

The principles announced in the following decisions of this Court and of various of the Courts of Appeals apply to the situation above disclosed.

In *Eisner* v. *Macomber*, 252 U. S. 189, l. c. 206 (64 L. Ed. 521, l. c. 528), the court said:

> "In order, therefore, that the clauses cited from Article I of the Constitution may have proper force and effect, save only as modified by the amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not 'income,' as the term is there used; and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised."

In *Bowers* v. *Kerbaugh*, 271 U. S. 170, l. c. 174 (70 L. Ed. l. c. 888), the Supreme Court again said:

> "In determining what constitutes income, substance rather than form is to be given controlling weight."

The court in *Tucker* v. *Alexander*, 25 F. (2d) 425, l. c. 428, said:

> "Substance and not form must govern in construing and applying income tax laws. *United States* v. *Phellis*, 257 U. S. 156, 168, 42 S. Ct. 63, 66 L. Ed. 180. The transaction must be viewed as a whole because it was a unit. Each step therein was necessary to its completion."

In *In re Harrington,* 1 F. (2d) 749, l. c. 750, it is said:

> "This is, of course, the fundamental purpose of the law that the taxpayer should be taxed upon his actual income and that this should neither be diminished nor increased by any arbitrary or artificial method of computation. As the law says, 'the true income must be clearly reflected,' and for this purpose the regular and long-standing methods of accounting employed by the taxpayer, established in due course and for no ulterior purpose, are to be indulged. * * * But, if the books are kept, as the record shows they are, to show the exact state of the income upon completed contracts in each year, it is not perceived how greater difficulty can arise in the case of engineers than in that of building and construction work generally. Furthermore, the government does not seek to secure a return upon income which is not accurate in fact and which casts an unjust burden upon the taxpayer."

In *In re Sheinman,* 14 F. (2d) 322, l. c. 325, the court said:

> "The ascertainment of the amount of the net taxable income of the taxpayer is the ascertainment of a fact. Real facts, and not bookkeeping entries, give rise to income. Books of account are no more than evidential. They are neither indispensible nor conclusive. *Doyle* v. *Mitchell,* 247 U. S. 179, 38 S. Ct. 467, 62 L. Ed. 1054; *Southern Pacific Railroad* v. *Muenter,* 260 F. 837, 171 C. C. A. 563; *Douglas* v. *Edwards,* (C. C. A.) 298 F. 229. *Baldwin Locomotive Works* v. *McCoach,* 221 F. 59, 136 C. C. A. 660."

Haugh & Keenan Storage & Transfer Co. v. *Heiner,* 20 F. (2d) 921, l. c. 922, states the following rule:

> "The government proceeded on the theory that because the books and records of the plaintiff did

not disclose depreciation provided for in a certain way, or according to a certain rule, therefore it must be presumed that depreciation was not provided for at all. Taxes are not laid and collected on theory, but on a situation actually existing, as the facts may show that situation to be. Theory is applied in the absence of such facts. The question of taxation is one of fact, and cannot turn on theories or fiction. *In re Curtis,* 142 N. Y. 219, 36 N. E. 887; *Swift's Estate,* 137 N. Y. 77, 32 N. E. 1096, 18 L. R. A. 709."

II.

As to the second proposition, the Circuit Court of Appeals held that the Inventory Statute and the Inventory Regulations are not applicable to the emergency material at all for the reason, among others, that, under the agreed facts, it clearly appears there was no income derived therefrom and consequently there can be no tax. We are not contending for the so-called "base," "constant" or "minimum" inventory theory, nor did the court below recognize or apply the same.

In the majority opinion, it is said (R. 34):

"The government urges that this is but another claim of the right to set up a 'minimum inventory' formerly but unsuccessfully claimed by retailers and dealers. If it is, then the appeal must fail. * * *"

In the minority opinion, it is said (R. 42):

"I understand it is not intended to strike down the acts and regulations concerning resort to inventory for income tax assessments, but the court discerns in the case of this taxpayer a peculiar situation amounting to an exception."

Inventories are not designed or resorted to to create income but to ascertain or determine income, and "• • • are necessary in business affairs according to the exigencies of each particular case" (Foulke, Federal Income Tax, Sec. 642).

If under any correct legal hypothesis relating to the business of manufacturers and dealers, an income resulting from a gain in inventory could be discovered as to them under as nearly an analogous state of facts as the nature of their business would warrant, the distinction will be apparent by the consideration of the normal relation which an inventory bears to their business, as compared to its non-relation to respondent's business. A taxable gain in inventory, as distinguished from a non-taxable growth or increment in value of property, is naturally and normally limited to a situation where the goods or merchandise constitute the subject matter or stock in trade of the business of the taxpayer, and not, as here, where property is not a necessity but a mere convenient facility for expeditious performance of contracts, or where, as here, the business, and the profits thereof, are disconnected with and not dependent upon such property.

The Departmental Regulation promulgated in pursuance of the Inventory Statute, shows its restricted application to cases in which the "production, purchase or sale of merchandise is an income producing factor," and thereby excludes from the effect thereof the contracting business of the respondent. It can not correctly be said that a building contractor is engaged in the business of "producing" or "manufacturing" a

building or structure, nor does he "sell" the same. The business of a building contractor is recognized, in the business world, as being entirely different and distinct from that of a manufacturer or producer of merchandise or commodities and also from that of a merchant or a dealer in merchandise or commodities. The fabrication of a steel beam or plate is no different from what a carpenter does with wood in fashioning it to fit in its allotted place in a building or structure. Steel, brick, concrete, stone and wood merely require different tools and equipment to "fabricate" and to handle them in connection with a building, bridge, or other structure.

The Regulation referred to (formerly Art. 1581, Reg. 45, now Art. 101, Reg. 74) reads as follows:

> "In order to reflect the net income correctly, inventories at the beginning and end of each year are necessary in every case in which the production, purchase or sale of merchandise is an income-producing factor. The inventory should include raw materials and supplies on hand that have been acquired for sale, consumption, or use in productive processes, together with all finished or partly finished goods. * * *"

The limitation of the statute was recognized by the Board of Tax Appeals in the case of *Atlantic Coast Realty Company* v. *Commissioner of Internal Revenue*, 11 B. T. A. 416, 419. This decision (a rather extensive extract from which is printed as an appendix to this brief) discusses the history of the Inventory Statute in connection with congressional action thereon, and concludes:

> "This carefully guarded language may not be construed as creating in all taxpayers the right

to determine income by the use of an inventory of property on hand. The use of inventories must be reasonably necessary to the determination of income. The basis of their use must be prescribed by the Commissioner, not arbitrarily, but in conformity to the best accounting practice in the trade or business and as most clearly reflecting income. The language indicates no intention to recognize in any trade a new method of determining income or a new limitation upon income, but only a recognition of the use of inventories in such trades or businesses like 'manufacturing and merchandise concerns,' as had been found to require such accounting practice."

The petitioner at page 11 of his brief in support of his petition for the writs of certiorari, says:

"This taxpayer is not a mere contractor, but a manufacturer who buys raw material in the form of plates and bars and fabricates it into the frame work of bridges and buildings. The steel it used did not all come direct from the mills, but a large part of it came from its own reserve supply. • • • The orders placed at the mills were not merely to take care of the particular job at hand, but also to replenish the reserve supply in preparation for anticipated future contracts.

The facts in this case, we submit, are therefore not unique; they are more or less typical of large numbers of other cases in which manufacturers maintain stocks of raw material for use in their productive processes. The stock here, like most other stocks, was kept in good faith; it was reasonable in amount; and it was necessitated by the remoteness of the more general supply."

In his final brief here, petitioner, in effect, makes the same contentions, contrary to the agreed facts. Respondent is not a manufacturer; material *is* ordered for each

job; and respondent buys no "raw material." What we have heretofore said sufficiently shows the nature and character of respondent's business and the stipulation of facts permits of no other conclusion than that reached by the court below that respondent is a building contractor and nothing else. The statement that respondent buys "raw material" from the rolling mills in the form of structural steel, bars and plates, discloses an entire misconception of what is and what is not raw material. As well say that a board or wooden beam, to which the saw and auger of the mechanic are applied, is raw material as to say that a steel beam or plate, to which a dissimilar saw and auger are applied is raw material. The operator of a sawmill manufactures lumber, but the building contractor who fits, fashions and places it in a building is not a manufacturer. Similarly, the processes by which iron ore and other ingredients are converted into steel and rolled into bars, beams and plates properly comes under the designation of manufacturing. But the building contractor who fits, fashions and places them in their allotted place in a building, bridge or other structure is not a manufacturer. And by the same token, the lumber and steel, as they reach the contractor, are not raw material.

The petitioner makes the point, by way of argument, that since the taxpayer and the Commissioner of Internal Revenue participated in the practice of inventorying the sometimes excess material (over and above the 5554 tons) the taxpayer thereby conceded the propriety of the application of the inventory regula-

tions to the emergency material in question. In answer to this point we cite the homely apothegm that, "two wrongs do not make a right." Such excess material should not have been inventoried at all; but, on the contrary, the cost thereof should have been figured into the contracts, thereby contributing to a profit or loss (as the case might be) in the performance of the contracts, determinative at the completion thereof. Such course would have been reflective of true income. This was, erroneously, not done, and, consequently the Commissioner of Internal Revenue and the taxpayer substituted the inappropriate practice of inventorying such excess material and a tax was calculated and assessed upon the increase in the value thereof. Such tax is not in controversy in this case. As pointed out, this method may very well have resulted in an erroneous tax (and necessarily did so result if the agreed method was likewise observed as to it) as the gain in inventory, in a given year, may have overcome and exceeded the losses resulting from the completed contracts themselves, thereby producing a tax without income; or, conversely, augmented its true income derived from its contracting operations, correspondingly (and improperly) increasing its tax. On this point the court below said (R. 34):

> "It is also urged that the appellant, during these very years, included as a part of its income, the increase in value of the excess of the emergency steel over 5554 tons, and thereby attested the correctness of the government's position. The conclusion does not follow. As to the excess, the appellant doubtless recognized that an emergency supply must bear a fair proportion to the re-

quirements of the business; having determined that 5554 tons was an adequate reserve for a business that fabricated about 30,000 tons a year, it should account for any excess above that amount. *Moreover, that the taxpayer may have paid more taxes than it should have, is not adequate reason for a disposition of this case*" (italics ours).

The case was decided by the Board of Tax Appeals upon the unwarranted assumption that respondent *sold* the emergency material, *collected* the proceeds thereof and *reinvested* it in other steel, patently disregarding the nature and character of respondent's business as a construction or building contractor. It said (R. 24):

> "In fact, however, each sale or exchange of the individual items of the inventory is a realization of taxable profit or deductible loss in the year in which it occurs, and a method of accounting which disregards such realization does not truly reflect income. After the profit is realized it is immaterial whether it is immediately reinvested in inventory or is invested in some other manner. It is taxable when realized."

There is no language in the stipulation of facts warranting such a construction or justifying such a conclusion. On the contrary, it is clearly stated that it "fabricates material for specific structures or contracts," that material "is ordered and procured from the mills for each specific structure or contract" and that the emergency material "has been kept on hand for emergency use (from which material is borrowed and replaced) to insure the prompt and orderly execution of contracts. * * *" May we ask how these sales were effected or the proceeds thereof collected and by

what manner or means the same could have been "invested in some other manner" or in material *already* "purchased and procured." There was no "sale," the relation of vendor and vendee at no time existing in any feature or aspect of respondent's contracting business. The board also overlooked or disregarded the fact that respondent's profits or losses accrue and are determinative as of the date of the completion of its construction contracts irrespective of when the contracts are made or the material is used or the work is done. A contract made August first and completed January tenth would, for tax purposes, belong to the latter year although ninety per cent of the work was done and ninety-five per cent of the material was used during the former year. The Board of Tax Appeals gave no heed or consideration to these true facts and conditions and consequently failed to see that this material and the use thereof contributed nothing to respondent's income, save only the indirect and incidental benefits resulting from the agreed purpose of the use thereof.

III.

Upon both issues, heretofore considered, that (a) there was no income upon which to assess the tax, and (b) the Inventory Statute and Regulations do not apply, we cite and adopt as a part of our brief and argument the following clear, analytical and accurate discussion found in the majority opinion of the court below (R. 37):

> "Is there any basis for determining that an inventory of this emergency steel is necessary in arriving at appellant's income, prior to the time

when it is liquidated? It is stipulated that the appellant 'carries no finished product in stock'; that is, unlike a retailer or wholesaler, or a miller, it is not a dealer. 'It fabricates material for specific structures or contracts'; that is, it gets a contract first, and then does the work. Except for the supply in question, and the excess inventory on which taxes are paid, 'material is ordered and procured from the mills for each specific structure or contract'; that is, it buys on the market and at the market for each job. Sometimes, when work is progressing, the material ordered is delayed in shipment or transit; rather than delay the job, then and then only—'for emergency use (from which material is borrowed and replaced)' —the reserve steel in question is resorted to. When it is so used, 'it is charged to the contract at its replacement cost and is promptly replaced with material of a like kind and in a like quantity';— presumably, as stated in argument, from the delayed car.

We have then this situation; the appellant is fabricating steel at Kansas City, some distance from steel mills; realizing the chance of delayed shipments, and in order to be able to compete in prompt execution of its contracts with other plants located near the mills, it carries a "stand-by" stock, replacing each girder used therefrom by the one ordered. There is in fact no profit at all realized from this emergency supply, other than the reputation of promptly doing the work. The profit of each job is exactly the same as if it had no such reserve. The profit is the same as if it borrowed the steel from a neighbor instead of from this pile. In fact, it might very well be that half this reserve steel would go into a bridge that showed a loss on the entire contract. The pile is the same on December 31, 1916, as it is on similar days in each succeeding year, except for the two years noted and not here involved. As long as it remains intact, there is no income from it, no

matter what the market fluctuations are. When, if ever, it is liquidated, there will then be a profit or loss, but until then it is like its derricks and its cranes and its buildings; it is useful in the business, but until liquidated, can show only paper profits which are neither realized nor taxable.

Upon argument it was urged that when the taxpayer took $1.70 steel out of the pile and put it in a $4.00 contract, he made a profit; and whether he reinvested that profit in other steel that went into the pile, is immaterial. This overlooks the stipulated facts. The taxpayer's contract was figured on $4.00 steel which he ordered from the factory; if a $1.70 girder was "borrowed" from the pile today, put into a bridge, and "replaced" tomorrow in "kind" with a $4.00 girder, there is no profit as long as he keeps the $4.00 girder for emergency use. In the briefs, it is argued that the appellant is like a merchant, who constantly replenishes his stock, always striving to keep a stock on hand to meet the demands of his trade. That but begs the question. In the first place, inventories are "necessary" for the multitudinous transactions of merchants, who buy first and sell afterward; they are not necessary for those who keep no finished stock, who sell no goods, and who always contract first and buy afterward. Moreover, merchants keep no standby stock for years, promptly replacing in kind each item borrowed therefrom.

Taking the whole business of the taxpayer, as stipulated, and bearing in mind the admonition that the substance and not the form controls, we cannot escape the conclusion that, as a matter of fact, the existence or absence of this emergency supply doesn't add a dollar to the profit the taxpayer made on any contract he has ever executed; under the facts, it cannot affect his income, except as a good reputation helps him to other contracts, upon which he will pay a tax."

Conclusion.

We have endeavored to show that there was no income upon which to assess the tax. If we have succeeded, then the Inventory Statute and Regulations are of no consequence in the decision of the case, for the tax was assessed as a tax upon income and if there was no income it follows there can be no tax. The court below announced no rule of law in conflict with any decision of this court or of any other of the Courts of Appeals. It merely construed the *agreed* facts, necessarily limited to this case, and applied the settled law to such restricted facts. The Commissioner of Internal Revenue cannot be heard to say to a taxpayer "I agree you have had no income but, nevertheless, I will assess an income tax against you because you have not observed a departmental regulation, the sole purpose of which is to ascertain and determine whether or not you enjoyed an income, which, as stated, I agree you did not." In language made classical by the Supreme Court of Missouri, he cannot "blow hot and cold."

Hence, when the time and event shall arise that the taxpayer liquidates the emergency material, then and not until then may the Commissioner of Internal Revenue assess a tax upon the income derived from such liquidation, viz., the difference between its original cost in 1916 of $1.70 per hundredweight f. o. b. Pittsburgh, or $2.136 per hundredweight f. o. b. Kansas City, upon the one hand, and the higher liquidating price received therefor, upon the other, similarly in all respects, as he might do if such material had re-

mained untouched and unmolested, preserved in its original form (as it was in substance) freed from the practice of borrowing and replacement set forth in the stipulation of facts upon which the case was tried; and if the liquidating price should be lower than such original cost, then, under the same formula of fact and law, the taxpayer may have the advantage thereof as an offset to its then earnings, with the resultant diminution of its taxable income.

The judgment of the court below (reversing the judgment of the Board of Tax Appeals) should be affirmed.

Respectfully submitted,

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APPENDIX.

Atlantic Cost Realty Company v. *Commissioner of Internal Revenue*, 11 B. T. A. 416, 418.

"The taxpayer with its affiliated corporation, was engaged in buying and selling land for profit. When it filed its consolidated return for 1918 it claimed for the first time that its income should be determined by the use of a so-called inventory of its lands at market value, and upon that basis it reported net income of $14,204.39 and paid a tax of $1,464.53. * * *

We are of opinion that the petitioner has no such right as it claims, that it may not determine its income by revaluing its lands from year to year, and therefore that there is no occasion for findings of fact as to market value of the parcels in question at the close of 1918.

Income is not ordinarily determined by the fluctuations in value of property upward or downward during the continuation of the same ownership. Increment is not added to, nor is a drop in value deducted from, earnings until it has been realized by a sale, loss or other cognizable disposition of the property. Section 203 is a departure from this and it must be limited to its apparent intendment as disclosed in its terms and if necessary in its history. It provides:

> 'That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.'

It was first enacted in the Revenue Act of 1918 and has remained unchanged in each of the later Acts of 1921, 1924 and 1926. In the report on the proposed 1918 Act made by the House Committee on Ways and Means, the Committee said:

> 'In many cases the only way that the net income can be determined is through the proper use of inventories. This is largely true in the case of manufacturing and merchandise concerns. The bill authorizes the Commissioner to require inventories whenever in his opinion the same is necessary in order clearly to reflect the income of the taxpayer.'

The Senate inserted the words 'conforming as nearly as may be to the best accounting practice in the trade or business,' and thus the section was enacted.

This carefully guarded language may not be construed as creating in all taxpayers the right to determine income by the use of an inventory of property on hand. The use of inventories must be reasonably necessary to the determination of income. The basis of their use must be prescribed by the Commissioner, not arbitrarily, but in conformity to the best accounting practice in the trade or business and as most clearly reflecting income. The language indicates no intention to recognize in any trade a new method of determining income or a new limitation upon income, but only a recognition of the use of inventories in such trades or businesses, like 'manufacturing and merchandise concerns,' as had been found to require such accounting practice."

* * * * * * * *

"It seems plain that the use of inventories is not practical in such a business. * * * Instead of being a more convenient method of accounting, as it is with large stocks of small merchandise being frequently turned over, it is so cumbersome and uncertain as to be generally impractical."